REINSURANCE ASSOCIATION OF AMERICA

STATEMENT

TESTIMONY

OF

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STATE OF THE INSURANCE INDUSTRY: EXAMINING THE CURRENT REGULATORY AND OVERSIGHT STRUCTURE

BEFORE

UNITED STATES SENATE
COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS

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My name is Frank Nutter and I am President of the Reinsurance Association of America (RAA). The RAA is a national trade association representing property and casualty companies that specialize in assuming reinsurance. RAA members are licensed, authorized or accredited in all US jurisdictions.

I am pleased to appear before you today to provide the reinsurance industry's perspective on the need for insurance regulatory reform. I commend Chairman Dodd and Senator Shelby for calling this important hearing and welcome the opportunity to address the Committee about why the current state system for regulating the reinsurance marketplace is in need of reform, particularly in those areas that affect the ability of US reinsurers to compete in the global marketplace and for needed reinsurance capacity. My testimony will highlight how US and foreign reinsurers doing business in the United States are regulated; why the current state-based insurance regulatory system does not work well for the sophisticated global marketplace; and explain the RAA's position in support of an optional federal charter for the reinsurance industry, or alternatively, federal legislation that streamlines the current state-based system.

I. BACKGROUND ON REINSURANCE

a. The US Reinsurance Market

Reinsurance is critical to the insurance marketplace. It reduces the volatility experienced by insurers and improves insurers' financial performance and security. It is widely recognized that reinsurance performs at least four primary functions in the marketplace: to limit liability on specific risks; to stabilize loss experience; to provide transfer for insurers of major natural and man-made catastrophe risk; and to increase insurance capacity.

I cannot emphasize enough the important role that reinsurance plays in the insurance marketplace. Reinsurers have assisted in the recovery from every major US catastrophe over the past century. By way of example, 60% of the losses related to the events of September 11 were absorbed by the global reinsurance industry and 61% of the 2005 hurricanes Katrina, Rita and Wilma were ultimately borne by reinsurers.

Reinsurance is a global business. Encouraging the participation of reinsurers worldwide is essential to providing the much needed capacity in the US for both property and casualty risks. This can be best illustrated by the number of reinsurers assuming risk from US ceding insurers. In 2007, more than 2,500 foreign reinsurers assumed business from US ceding insurers. Those 2,500 reinsurers were domiciled in more than 70 foreign jurisdictions.[1] Although the majority of US premiums ceded offshore is assumed by reinsurers domiciled in a dozen countries, the entire market is required to bring much needed capital and capacity to support the extraordinary risk exposure in the US and to spread the risk throughout the world's financial markets. Foreign reinsurers now account for 56% of the US premium ceded directly to unaffiliated reinsurers; a figure that has grown steadily from 38% in 1997.

b. US Reinsurance Regulation – Direct and Indirect

Reinsurance and US reinsurers are currently regulated on a multi-state basis, a system which is cumbersome and inefficient for a global marketplace. Complying with varying regulatory laws in fifty states makes compliance unnecessarily burdensome and expensive for this global business. While the current state-based insurance regulatory system is primarily focused on regulating market conduct, contract terms, rates and consumer protection, reinsurance

[1] Reinsurance Association of America (RAA), Offshore Reinsurance in the US Market 2007 Data (2008).

regulation focuses on ensuring the reinsurer's financial solvency so that it can meet its obligations to its ceding insurers.

The US employs two methods of reinsurance regulation: direct regulation of licensed US reinsurers and indirect regulation of the reinsurance transaction ceded by US insurers to unauthorized reinsurers.

States directly regulate reinsurers that are licensed in the US. Although regulators do not impose regulatory requirements for the rates that can be charged for reinsurance or the forms that can be used to evidence the contractual terms, reinsurers licensed in at least one US state are subject to the full spectrum of solvency laws and regulations that a primary insurer is subjected to.

To fulfill the larger demands of the US-market, there is a need for substantial reinsurance capacity. As a result, US regulators do not prohibit non-US reinsurers from assuming reinsurance business in the US, nor does the system presume that they have the regulatory capability or resources to assess the financial strength or claims paying ability of non-US reinsurers. Instead, the US has developed a system of indirect regulation whereby the reinsurance transaction is regulated through the credit for reinsurance mechanism. Credit for reinsurance is the financial statement accounting effect given to a ceding insurer if cessions are ceded in accordance with prescribed criteria. If the criteria are met, the ceding insurer may record a reduction in insurance liabilities for the effect of the reinsurance transactions.

The fundamental concept underlying the US regulatory system is that a reinsurer must either be licensed and subject to the full spectrum of multi-state reinsurance regulation, or provide collateral to ensure the payment of the reinsurer's obligations to US ceding insurers.

For several reasons, including the cumbersome nature of a multi-state licensing system, capital providers to the reinsurance market have in recent years opted for establishing a platform outside the US and conducting business through a US subsidiary or by providing financial security through a trust or with collateral. Following the 1992 hurricane season, eight new reinsurers were formed with $4 billion of new capital. Following the events of September 11, 2001, 12 new reinsurers with $10.6 billion capital were formed. After Hurricane Katrina, at least 38 new reinsurance entities with $17 billion of new capital were formed. Nearly all of this new capital came from US capital markets yet no new reinsurer was formed in the United States. Other than the US subsidiaries of some of these new companies, no new US-domiciled reinsurer has been formed since 1989. For these startups, the ease of establishment, capital formation, and regulatory approvals in non-US jurisdictions contrasts with the cumbersome and protracted nature of obtaining licenses in multiple US states.

II. KEY ISSUES FOR THE US REINSURANCE INDUSTRY

The RAA seeks to change the current regulatory structure, and advocates a modified optional federal charter for reinsurance to allow a reinsurer to choose between a single federal regulator or remain in the current 50-state system. Alternatively, the RAA seeks federal legislation that streamlines the current state-based system. There are a number of key problems and inefficiencies with the current state-based framework for reinsurance regulation, which has led the RAA to advocate a federal role.

a. A Need for a Single Federal Voice for the Global Reinsurance Industry

The recent US Treasury's Blueprint for Financial Regulatory Reform ("the Treasury Blueprint") noted that the US state-based insurance regulatory system creates increasing tensions in this global marketplace, both in the ability of US-based firms to compete abroad and in the allowance of greater participation of foreign firms in the US market. Foreign government officials have continued to raise issues associated with dealing with 50 different US insurance regulators, which makes coordination on international insurance issues difficult for foreign regulators and companies.

"The Treasury Blueprint" also noted that while the NAIC attempts to facilitate communication among the states on international regulatory issues, it is not a regulator. "The Blueprint" further noted that because of the NAIC's status as a non-governmental coordinating body and the inherent patchwork nature of the state-based system, it will be increasingly more difficult for the US to speak effectively with one voice on international regulatory issues.

This lack of a single voice is already adversely impacting US reinsurers. "The Treasury Blueprint" points out that the interaction between the US and its foreign counterparts on issues like the European Union's Solvency II will likely impact not only the ability of US companies to conduct business abroad, but also the flow of capital to the US. For US reinsurers, Solvency II will set forth a process for determining which countries are "equivalent" for purposes of doing business in the European Union. Although this issue is still being discussed, it is our understanding that the European Parliament recently obtained a legal opinion that stated that the European Commission cannot grant equivalence to a US state under Solvency II. The possibility that the entire 50-state system in the US will be deemed "equivalent" appears questionable. Thus, without federal involvement by a knowledgeable entity tasked with responsibility for international policy issues, the US reinsurance industry will continue to be disadvantaged in these equivalence discussions.

An informed federal voice with the authority to establish federal policy on international issues is critical not only to US reinsurers, which do business globally and spread risk around the world, but also to foreign reinsurers, who play an important role in assuming risk in the US marketplace. The fragmented US regulatory system is an anomaly in the global insurance regulatory world. As the rest of the world continues to work towards global regulatory harmonization and international standards, the US is disadvantaged by the lack of a federal entity with authority to make decisions for the country and to negotiate international insurance agreements or federally enabling legislation which empowers a single state regulator to do so.

b. Mutual Recognition

US states impose a highly structured and conservative level of regulation on licensed reinsurers. However, it has long been recognized that the level of reinsurance regulation varies substantially throughout the world.

While some countries impose what has been characterized as “equal or nearly equal treatment” of “professional” reinsurers[2] and direct insurers,[3] other countries employ a “reduced regime” of direct supervision.[4] And still others combine some elements of direct supervision with indirect supervision.[5] There are several globally recognized methods of conducting reinsurance regulation.[6]

The RAA is encouraged by the inclusion of a system of mutual recognition among countries in S. 40 (The National Insurance Act of 2008). Mutual recognition seeks to establish a system where a country recognizes the reinsurance regulatory system of other countries and allows reinsurers to conduct business based on the regulatory requirements of its home jurisdiction. If such a system were established, European reinsurers would be permitted, for example, to assume reinsurance risk from the US without having to obtain a US license and without having a requirement in law to provide collateral for their liabilities to US ceding

[2] The term “professional reinsurers” is used here only for clarity. It is not typically used in the U.S.
[3] Denmark, United Kingdom, Finland and Portugal.
[4] Id. Austria, Italy, Spain and Sweden.
[5] See id. Germany, France and the Netherlands.
[6] Id.

insurers. In return, such a system would allow US reinsurers to conduct business in the mutually recognized country based on its US regulatory oversight.

A single national regulator with federal statutory authority could negotiate an agreement with the regulatory systems of foreign jurisdictions that can achieve a level of trust and confidence with their counterparts in the US. The foreign regulatory regime need not be identical to the US regulatory system, but one that has substantially equivalent standards and regulatory enforcement.

c. <u>Credit for Reinsurance</u>

US state laws providing for the circumstances under which ceding insurers may take financial statement credit are the cornerstone of state reinsurance regulation. While there are differences among the states, those laws are based in substantial part[7] on the NAIC model law and regulation governing credit for reinsurance.[8]

The NAIC model law and regulation has been the subject of much debate in recent years. Some non-US reinsurers have advocated the reduction of collateral for those reinsurers that choose not to be subject to direct US licensing and reinsurance regulation. Advocates of this reduced security represent that US collateral requirements impede competition and are unnecessary in a business that is increasingly global. US primary insurers have generally opposed this effort, contending it weakens US regulation and dilutes the financial security of US insurers and their policyholders.

While non-US reinsurers have the option of being licensed to do business in the US, state regulation has attempted to strike a balance between creating and maintaining an open

[7] There are significant deviations among the states, particularly in the area of extra-territorial application of state laws as discussed below.
[8] Credit for Reinsurance Model Law, Vol. –785 (National Association of Insurance Commissioners 1996) and Credit for Reinsurance Model Regulation, V-786 (National Association of Insurance Commissioners 1996).

marketplace, while ensuring the financial security of ceding insurers and their policyholders. As the world's largest insurance marketplace, the US is dependent on non-US and US reinsurance capacity. At the same time, 50 state regulators cannot be expected to know, or to learn, the intricacies of accounting systems and regulatory schemes used throughout the world to determine the financial strength of non-US reinsurers. Currently, the ceding US insurer is allowed financial statement credit for cessions to such non-US reinsurers, based on state laws that require collateralization of the reinsurer's obligations. Collateralization eliminates the regulator's need to assess the level of regulation in the non-US reinsurer's domiciliary jurisdiction or the financial strength of the particular reinsurer. It also reflects the challenges facing 50 state regulators with resource constraints and competing regulatory demands. Unfortunately, initiatives by some states suggest the risk of a patchwork of state laws relating to financial security may be emerging.

The RAA believes that it is essential to maintain a strong, but uniform, regulatory structure in the US. In that regard, the RAA commends the sponsors of S.40 (The National Insurance Act of 2008) for proposing an optional federal charter for insurers. In large part, this will address the RAA's concerns over uniformity of applicable law. We are also encouraged by the ongoing efforts of the NAIC to develop a framework for reinsurance regulation which seeks to streamline regulation through a national system for US reinsurers, a port of entry for non-US reinsurers and a system of trans-border regulatory recognition. We have encouraged the NAIC to seek federal legislation to achieve this system.

d. Extra-Territorial Application of Law

The RAA believes there is a need for greater efficiency in the regulation of reinsurance. As a result of our 50-state system of regulation, significant differences have emerged among the states with respect to reinsurance regulatory requirements. Multi-state systems add extra costs to transactions, and these are ultimately reflected in the premiums paid by consumers. The NAIC and state regulators are to be applauded for their efforts toward greater uniformity in the adoption of model laws and regulations and the creation of the accreditation system; yet, this has not prevented some states from pursuing varying and sometimes inconsistent regulatory approaches. One of the best examples of this is the extra-territorial application of state laws.

Thirteen states apply at least some of their regulatory laws on an extra-territorial basis, meaning that the state law not only applies to the insurers domiciled in that state, but to insurers domiciled in other states if the extra-territorial state has granted a license to the insurer. For example, an insurer domiciled in a state other than New York, but licensed in New York, will find that New York asserts that its laws apply to the way it conducts its business nationwide. Since most US based reinsurers are licensed in all 50 states, this extra-territorial application of state law results in inconsistencies among state laws. States applying at least some of their laws extra-territorially include: California, Florida, Kentucky, Maryland, Michigan, New Jersey, New Mexico, New York, Pennsylvania, Texas, Utah, Virginia and West Virginia.

As Congress proceeds to review the current regulatory structure and consider a new one for the future, we encourage the Committee to focus on streamlining reinsurance regulation to allow US reinsurers to be more competitive in the global marketplace. Any structure that is adopted should eliminate duplicative and inconsistent regulation like that which is caused by the extra-territorial application of state laws. We applaud the sponsors of S.929 (The Non-Admitted and Reinsurance Reform Act of 2007) for proposing legislation that will eliminate the extraterritorial application of laws.

III. GOALS OF EFFECTIVE REINSURANCE REGULATION AND CORE CHARACTERISTICS OF A REINSURANCE REGULATORY REGIME

The way in which reinsurers do business in the US is changing; the products and services they offer is evolving, and the range and characteristics of their competitors and their clients is expanding. Reinsurers have been in the forefront of advocating greater regulatory efficiencies to expand capacity in a global marketplace.

Technologies, global events and convergence of financial markets combine to offer the opportunity to effect fundamental change to the insurance and reinsurance regulatory regimes that have existed in the past. This opportunity carries with it the burden of ensuring that the critical balance between efficiency and financial security is reached.

The goals of effective reinsurance regulation in the United States should be to promote:

1. Financially-secure reinsurance recoverables and capacity that protects the solvency of US ceding insurers.
2. A competitive and healthy reinsurance market that provides sufficient capacity to meet ceding companies' risk management needs.
3. Effective and efficient national reinsurance regulation.

The core characteristics of an appropriate reinsurance regulatory structure that would assist in achieving these goals should include:

1. A single regulator or regulatory system for reinsurance with national regulatory oversight and the power to preempt conflicting or inconsistent state laws and regulations in an effective and efficient manner.

2. The single regulator's authority should provide for the recognition of substantially equivalent regulatory standards and enforcement in other competent regulatory jurisdictions.
3. The regulatory structure should support global capital and risk management, taking into account capital adequacy, assessment of internal controls, recognition of qualified internal capital models and effective corporate governance.
4. The regulatory structure should provide for financial transparency that encourages and supports the cedents' ability to assess counter-party credit risk, including information regarding the reinsurer's financial condition and the reinsurer's performance in paying covered claims.
5. Regulators should have access to all necessary financial information with appropriate provision for the confidentiality of that information, as currently provided for under state law and regulatory practice.
6. The regulatory structure should have an effective transition mechanism between the current system and any future regime that is consistent with these core characteristics. Absent mutual agreement of the parties, any reduction in existing collateral requirements should only apply prospectively.
7. The regulatory structure should utilize principles-based regulation where appropriate.

Changes to the current reinsurance regulatory structure to achieve these goals and core characteristics, include but are not limited to: (1) an optional federal charter which allows a reinsurer to remain in the 50-state system or obtain a federal charter and be regulated at the federal level pursuant to federal standards; or (2) a modified optional federal charter which allows a reinsurer to choose between a single federal regulator, a single state regulator or remain in the current 50-state system; and (3) federal legislation that streamlines the current state system. The RAA has a strong preference for a modified optional federal charter.

At its December 2007 meeting, the National Association of Insurance Commissioners embraced change along the lines the RAA proposes. The NAIC's Reinsurance Task Force acknowledged that "in light of the evolving international marketplace, the time is ripe to consider the question of whether a different type of regulatory framework for reinsurance in the US is warranted." The new framework being developed would "facilitate cross-border transactions and enhance competition within the US market, while ensuring the US insurers and policyholders are adequately protected." The Reinsurance Task Force proposes to modernize the US reinsurance regulatory system through a system of regulatory recognition of foreign jurisdictions, a single state regulator for US licensed reinsurers, and a port of entry state for non-US based reinsurers. Concerned with the challenges of implementing changes in all 50 states and questions of constitutional authority for state action on matters of international trade, the RAA has encouraged the NAIC to embrace federal legislation to accomplish their proposed framework.

The RAA thanks Chairman Dodd and Ranking Member Shelby for this opportunity to comment on reinsurance regulation, and we look forward to working with all members of the Committee as it considers this most important issue.